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OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

TAX AND BUDGET ISSUES RELATED TO LEASING BY NONTAXABLE ENTITIES

MAY 25, 1983

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May 25, 1983

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

This letter transmits the report of the Subcommittee on Oversight regarding tax and budget issues related to leasing arrangements by the Federal Government and other non-taxable entities. For purposes of analyzing these issues, the Subcommittee held a public hearing on February 28, 1983, which focused on lease/charter arrangements entered into by the Department of the Navy for certain ships.

The report includes a summary of the testimony presented to the Subcommittee during its hearing and the Subcommittee's findings and recommendations. Also attached is a copy of a Joint Committee on Taxation staff study done at the Subcommittee's request entitled Tax Aspects of Federal Leasing Arrangements. A brief description and discussion of the Subcommittee's findings and/or recommendations follows:

A. Federal Government long-term leasing of major assets is more costly than purchase of the same assets.

Explanation:

Economic analysis leads to the conclusion that the Government's capital cost is greater when it leases property on a long-term basis than when it buys the same property. When it leases property, the Federal Government's capital cost consists of rental payments and the revenue loss as a result of net tax benefits available to the lessor. For the lessor to be willing to enter into the lease, these rental payments and net tax benefits must be large enough to cover the lessor's capital costs, which are the following: interest and principal payments to lenders for loans used to acquire the property, a rate of return on equity provided by investors and used to purchase the property, any fees paid to third parties for setting up and carrying out the lease, and the

decline in the value of the property as it ages. The market rate of interest paid by the lessor and the rate of return expected by its shareholders generally exceed the interest rate on Government bonds, because of the Government's superior credit. Therefore, when the Federal Government leases, it compensates the lessor for greater financing costs than it would have borne had it borrowed funds and purchased the property. Similarly, to the extent that increased transaction costs are involved in arranging a sale and lease, and not merely a sale, the government compensates the lessor for expenses that the government would not have otherwise borne.

This additional capital cost of leasing does not necessarily mean that all Federal leasing is inappropriate; there may be considerations that outweigh its extra cost. However, it does suggest that there should be a presumption against long-term leasing by the Federal government.

B. A uniform government-wide accounting method is needed to provide an accurate analysis of the total costs of long-term Government leasing programs. Executive Branch review procedures regarding multi-year lease transactions should incorporate this method.

Explanation:

Federal agencies develop and analyze budget and procurement requests based on guidelines established by OMB. For capital budgeting purposes, Federal agencies are required by the Office of Management and Budget (OMB) to assess the costs of multi-year outlay programs. However, with regard to leasing transactions, OMB guidelines do not currently require agencies to consider the revenue loss as a result of tax benefits available to lessors in making the cost analysis. Federal procurement policies and implementing regulations cover primarily the direct purchase of goods and services and only indirectly address leasing transactions. In addition, OMB evaluates the budget requests of each agency. OMB does not currently assess the total costs (outlays and revenue loss) of proposed leasing transactions as part of its agency review activities, and the Treasury Department is not required to provide revenue loss estimates for such proposals.

At the Subcommittee's request, the staff of the Joint Committee on Taxation (JCT) developed a method of accounting for Government leases which includes an analysis of total Government costs, including revenue loss as a result of lessor tax benefits.

Recommendation:

1. OMB should promulgate specific guidelines regarding methodology for assessing the total Government cost of

long-term leasing proposals, including the revenue loss resulting from lessor tax benefits and loss of residual value.

2. The Department of Treasury and OMB should comprehensively review the legal, revenue and budget effects of proposed agency leasing transactions. The Department of Treasury should prepare revenue loss estimates for proposed long-term leases with durations of more than 50 percent of the useful life of the property.

C. Congressional review procedures regarding proposed long-term lease transactions can be improved.

Explanation:

The Subcommittee has identified only two notice or approval provisions regarding proposed long-term lease transactions under existing law. Congressional approval is required for real property leases with annual rental charges in excess of $500,000. In addition, the fiscal year 1983 Defense Authorization Act (P.L. 97-252) contains a notification requirement for certain Navy lease/charter transactions.

Recommendation:

1. Prior to the issuance of Request For Proposals (RFP's) for certain multi-year lease transactions, agency authorizing Committees and the Committees on Appropriations and the taxwriting Committees should be notified. Multi-year lease transactions with durations more than 50 percent of the useful life of the property should receive prior Committee notification.

2. Agency notices or approval requests should contain information on the total costs of the lease (outlays and revenue loss estimates) and a justification of leasing as the procurement method rather than direct purchase.

D. Congressional intent regarding the availability of the investment tax credit for lessors who lease property to the Federal Government or other nontaxable entities for tax-exempt activities should be clarified.

Explanation:

The investment tax credit (ITC) is unavailable with respect to property that is used by a governmental unit (governmental use restriction) and with respect to property used by a tax-exempt organization unless the property is used predominately in an unrelated trade or business of that organization. With respect to the governmental use restriction, one court has held (and the Internal Revenue Service has ruled) that the investment tax credit can be claimed where

the governmental unit essentially has contracted for a service to be provided by the owner of the equipment rather than for the use of the equipment itself. This makes it relatively easy to avoid the denial of the investment tax credit by restructuring leases as service contracts.

Recommendation:

Clarify by statute that the investment tax credit is not available for property used by nontaxable entities and obtained by a long-term lease structured as a service contract or similar arrangement.

E. Congress should reexamine cost recovery deductions for lessors who enter into long-term lease transactions or similar arrangements with the Federal government or other nontaxable entities.

Explanation:

As a general rule, entities such as Federal agencies, State and local governments, and charitable and educational organizations are ineligible to take cost recovery deductions (or the investment tax credit) when they purchase property because they are tax-exempt. In certain circumstances, the law permits taxable companies to purchase and claim certain tax benefits on assets which are subsequently leased to nonprofit entities. In these lease transactions a portion of the tax benefit available to the lessor may be passed through to the nontaxable lessee in the form of lower rents. Thus, certain leasing arrangements permit tax benefits to flow through to nontaxable entities which are not eligible for them on their own account. This can result in a negative effective tax rate on the assets leased by nontaxable entities. In effect, nontaxable entities through leasing receive the benefits of income tax deductions (and in unusual cases investment credits) but, unlike taxable entities, have no corresponding liability to pay income tax.

In addition to revenue sharing and grant programs, Congress also assists nontaxable entities through the tax system by means of the exclusion from federal tax of interest paid on municipal bonds. The 1982 combined cost to the Treasury of the exclusion of interest on State and local housing, pollution control, hospital, industrial development, and general purpose bonds was over $10 billion. Leasing increases the amount of assistance that State and local governments recieve through the tax system. (In some instances, State and local governments combine the benefits of leasing and tax-exempt debt in the same transaction -- tax-exempt leverage lease financing.)

Recommendation:

Congress should consider limiting cost recovery deductions for property leased to nontaxable entities so that the

tax system does not make leasing more attractive to these entities than direct ownership. These rules should be extended to arrangements similar to leases (e.g. service contracts).

F. Many recent transactions, including the Navy lease transactions, are premised on questionable assumptions regarding the determination of whether the transaction is a "true" lease as opposed to a financing mechanism or similar arrangement.

Explanation

Leasing is an established method of obtaining the use of property where direct ownership is undesirable because, for example, use of the property for only a small fraction of its useful life is desired (e.g., renting a car), cash flow or credit problems restrict the ability for direct property acquisition or because of State or Federal law restrictions on the ownership of the property (e.g., banking law restriction on the ability of banks to own certain property).

In many cases, government entities and other nontaxable entities lease for these same nontax business reasons. However, in other cases, nontaxable entities who otherwise would choose to own property have entered into transactions characterized by the parties as leases because they can obtain indirectly, in the form of lower rents, tax benefits that are not allowed for property owned by nontaxable entities. These tax benefits come directly out of the Treasury's receipts and increase the Federal deficit. In these situations (i.e. those in which the nontaxable entity would probably have chosen direct ownership) the parties have sought to designate the taxable lessor as the property owner for Federal tax purposes, while to the extent possible place the economic burdens and benefits of ownership on the nontaxable lessee. These transactions, which are exemplified by the Navy lease transactions examined by the Subcommittee, blur the distinction made in the tax law between "true" leases and financing arrangements or conditional sales and may permit a Federal tax subsidy on the basis of the form rather than the substance of the transaction.

The rules governing the determination of whether a transaction is a lease as opposed to a financing arrangement are not clear. In general, a transaction may qualify as a lease only if the lessor retains meaningful benefits and burdens of ownership. In the Navy lease transactions, the benefits and burdens of ownership retained by the lessor were very limited. Although the lessor, and not the Navy, would be entitled to any residual value at the end of the lease, the effect of placing this economic benefit with the lessor is lessened by the fact that the parties have estimated that the ship will only have a value at the end of the lease of

less than 1 percent of the purchase price. In combination, these factors raise serious questions as to whether the transaction is a lease. The Internal Revenue Service has, however, issued a private letter ruling granting lease treatment for a lease of ships by the Federal government, the terms of which are similar in many respects to the Navy transactions. Although private letter rulings cannot be used as precedents, the ruling creates disturbing implications. The Subcommittee is concerned about any developments that would, in effect, permit nontaxable entities to obtain a Federal tax subsidy by making minimal changes in the economic substance of transactions (normally structured as purchases), so that these transactions may qualify as leases eligible for tax benefits.

Mr. Chairman, the Subcommittee respectfully submits its analysis of these issues for your consideration.

Sincerely yours,

Charles B. Rangel
Chairman

CBR/wkvl

Enclosures

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TAX AND BUDGET ISSUES RELATED TO LEASING BY NONTAXABLE ENTITIES

I. INTRODUCTION

Under current law, a taxpayer may be allowed as a depreciation deduction for eligible property a reasonable allowance for the exhauston, wear and tear, or obsolescence of the property. The Economic Recovery Tax Act of 1981 (P.L. 97-34) established a system for recovering capital costs using accelerated methods over predetermined recovery periods (Accelerated Cost Recovery System--ACRS). In addition, for certain property taxpayers may claim an investment tax credit (ITC) of up to 10 percent of the cost of the property, in addition to depreciation deductions.

As a general rule, nonprofit entities such as Federal Government departments and agencies, State and local governments, and charitable and educational organizations receive no benefit from cost recovery deductions or the investment tax credit because they are tax-exempt. However, in some circumstances, the law permits taxable companies to purchase and claim certain tax benefits on assets which are subsequently leased to non-taxable entities. In these lease transactions a portion of the tax benefits available to the lessor may be passed through to the nontaxable lessee in the form of lower rents. Thus, the leasing arrangement may permit certain tax benefits to flow through to nontaxable entities which are not eligible for them on their own account. This can result in a negative effective tax rate on the assets leased by nontaxable entities because they receive many tax benefits but, unlike taxable entities, do not pay tax on the income generated by these assets. Because the tax benefits obtained through leasing reduce Federal revenues (and increase the Federal deficit), a portion of the property's cost is shifted to the U. S. Treasury.

II. PURPOSE OF THE OVERSIGHT SUBCOMMITTEE HEARING

The Subcommittee on Oversight conducted a public hearing on February 28, 1983 on tax aspects and policy issues related to leasing arrangements by the Federal Government and other nontaxable entities. The purpose of the hearing was to obtain information on leasing practices by nontaxable entities and to examine related tax and budget policy issues. In particular, the Subcommittee sought information regarding lease transactions by nontaxable entities which involved ACRS and ITC tax benefits.

Issues of concern to the Members of the Subcommittee included:

--the cost of such leasing arrangements as compared to outright purchases, in particular, the extent of revenue loss to the Federal Treasury;

--the extent and scope of Federal (and other non-taxable entity) leasing activities, and whether Federal agencies consider total government costs (outlays and revenue loss) in analyzing lease versus purchase options;

--Federal policies regarding leasing and the extent to which procurement policies at all levels of government are influenced by tax laws and potential tax benefits available to lessors;

--the appropriate methodology for detemining the total costs of Federal leasing;

--whether Congress intended that non-taxable entities by leasing property receive tax benefits for which they would not be eligible if they purchased the property; and

--whether Federal leasing proposals receive adequate review and are accounted for properly in the Federal budget.

For purposes of analyzing the issues of concern to the Members of the Subcommittee, the hearing examined recent lease/charter arrangements entered into by the Department of the Navy for 13 TAKX prepositioning ships designed to provide sealift support for U.S. rapid deployment forces. The Subcommittee did not seek to pass judgment on the Navy's need for these ships (and does not do so at this time), but focused

on the tax and budget policy issues that arise from leasing as a mode of procurement. The Navy greatly assisted the Subcommittee by providing contract documents concerning the lease/charter arrangements.

III. STATEMENT OF FACTS: NAVY'S CHARTER OF TAKX SHIPS

The TAKX program was authorized in 1979 by the Secretary of Defense in order to provide sealift support for the rapid deployment of the marine amphibious brigades to crisis areas. TAKX ships are built-to-purpose, roll-on-roll-off, container ships which have self-sustaining capabilities to load and unload cargo in areas without port facilities.

Initially, the Navy proposed to finance, construct, and own the TAKX ships. Ultimately, the proposal to own the TAKX ships was replaced with a proposal to charter the required ships. The decision to charter ships was based on two studies, conducted at the Navy's request by a national accounting firm and an economic consultant, which concluded that the Navy could charter a TAKX ship for as much as 35 percent less than the cost of purchasing the ship.

Under the TAKX lease/charter arrangement, the Navy has contracted for services to be performed by TAKX ships. The services to be performed are the transportation of equipment, cargo, and personnel on a time charter basis. That is, the TAKX ships are to be owned, operated, and maintained by private parties for the sole benefit of the Navy for a specified period of time.

The original proposal for the charter arrangement was unacceptable to prospective contractors because the proposal would have required the contractors to assume significant economic risks. While the structure of the original proposal was maintained, the final charter arrangement places significant economic risks upon the Navy, most of which are similar to the risks the Navy would have borne had it owned the ship outright.

Anticipated tax benefits for the shipowner are also significant components of the lease/charter arrangements. The parties anticipate that the ships will be eligible for ACRS and the investment tax credit (ITC). The Navy's capital hire (i.e., rent) payments take into account the shipowner's net income and tax benefits (and any changes therein resulting

from modifications of the tax laws).[1] In addition, the Navy is obligated to make the shipowner whole if he suffers loss of tax benefits as a result of the agreement being treated as a lease for Federal income tax purposes. (e.g., denial of investment credits). Appendix A summarizes features of the TAKX lease/charter arrangements.

IV. SUMMARY OF HEARING TESTIMONY

The Subcommittee received testimony from Members of Congress and witnesses representing the Department of Defense (DOD), the Department of the Navy (Navy), the Department of Air Force (Air Force), the Department of Treasury (Treasury), the Office of Management and Budget (OMB), the General Accounting Office (GAO), and the General Services Administration (GSA), (See Appendix D for witness list.)

The first witness, the Honorable Howard G. Metzenbaum (U.S.S., Ohio) discussed the cost of Navy TAKX lease/charter arrangements. He expressed concern that the lease arrangements were more costly to the Federal Government than direct purchase of the TAKX ships. The Honorable Donald J. Pease, (M.C., Ohio) also discussed the costs of leasing and questioned the lack of Federal control over selection of construction sites and contractors. Both the Honorable Roy Dyson (M.C., Maryland) and the Honorable Duncan Hunter (M.C., California)--who submitted a statement for the record--urged the Subcommitee to consider the TAKX leasing program in light of its positive effects on the shipbuilding and maritime industry.

Re-occurring issues at the hearing were the cost of leasing as compared to direct purchase, and the proper methodology for assessing both government outlay and tax expenditures. David H. Brockway, Chief of Staff, Joint Committee on Taxation (JCT), summarized a JCT study regarding Federal costs and tax aspects of the TAKX leases. He stated that based on the JCT analysis of one TAKX agreement, the total government cost of leasing would be approximately 12 percent greater than direct purchase because of tax benefits potentially available to the shipowner. Mr. Brockway described an economic method of accounting for Government leases and also discussed tax policy issues which apply generally to leasing by nontaxable entities.

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[1] The capital hire payments were calculated on the basis of the Federal income tax law in effect at the time the agreement to Charter was entered into. The Time Charter agreement made available to the staff was entered into before enactment of the changes made by the Tax Equity and Fiscal Responsibility Act of 1982, which, for example reduced the cost of property eligible for ACRS deductions by one-half of the investment tax credit allowed (Act §205). Thus, the Navy's capital hire payments already are subject to an upward adjustment.

Mr. Werner Grosshans, Deputy Director Procurement, Logistics and Readiness Division, (GAO), testified on behalf of the Comptroller General. Mr. Grosshans summarized the findings of a 1973 GAO report concerning the Navy's build and lease/charter program for nine tanker ships. At that time, GAO found that the Navy cost analysis of the tanker lease/charter program did not reflect the tax effects of this type of transaction, and that tax benefits available to the ship lessor (and not available in a direct purchase transaction) were an important factor in arranging the transaction. Mr. Grosshans recommended that proposed long-term transactions should receive prior Congressional approval and that cost analysis of lease arrangements should include outlay and revenue loss estimates. Mr. Grosshans also recommended that the Office of Management and Budget establish clear guidelines regarding long-term lease versus purchase analysis.

Mr. William A. Long, Deputy Under-Secretary for Acquisition Management (DOD) at the time of the hearings, Mr. Everett Pyatt, Principal Deputy Assistant Secretary Shipbuilding and Logistics (Navy), and Mr. Lloyd K. Mosemann, Deputy Assistant Secretary for Logistics and Communications (Air Force), testified regarding military leasing activities. Mr. Long stated that within DOD, the Office of the Secretary reviews agency lease proposals, including cost estimates. He emphasized that nonfinancial considerations may also be taken into account.

Mr. Everett Pyatt discussed prior Navy lease/charter programs and stated that the TAKX charters were structured to utilize standard leveraged lease financing. He said, as a result, the tax benefits to shipowners would also benefit the Navy in the form of reduced lease/charter payments. With regard to the total government lease costs, Mr. Pyatt testified that the Navy attempted to calculate both outlay and tax expenditures but stated that existing guidelines for making the evaluation were inadequate. Mr. Pyatt also pointed out that the TAKX program would support the U. S. shipbuilding industry and provide employment.

Mr. Lloyd Mosemann testified, due to its inability to obtain procurement funds, that the Air Force was considering plans to lease 120 aircraft to replace existing CT-39 aircraft (analogous to civilian executive jets), 3 C140B aircraft, and 202 tanker transport bomber trainers (which are modified commercial aircraft). Mr. Mosemann commented on the lack of specific OMB policy guidelines regarding leasing other than OMB Circular A-104 which pertains to the leasing of real property. He stated the Air Force has found Circular A-104 not very useful. Mr. Mosemann candidly stated that the Air Force's decision to lease aircraft was based more on exigency than cost analysis of leasing versus direct purchase.

Mr. J. Gregory Ballentine, Deputy Assistant Secretary, Tax Analysis (Treasury) testified that proper accounting for the costs of a Government lease arrangement must include the revenue loss from tax benefits available to property lessors and discussed the need for uniform procedures for evaluating lease versus purchase options. He indicated that to the extent a lease arrangement simply involves the substitution of private financing for public financing, it is more costly than a direct purchase. However, Mr. Ballentine cautioned that in appropriate cases the additional cost of leasing may be balanced by other policy considerations. He emphasized the tax treatment of a lease will depend on the facts and circumstances of the particular transaction and indicated Internal Revenue Service (IRS) guidelines outline the circumstances under which advance IRS rulings will be issued.

Mr. Donald E. Sowle, Administrator for Federal Procurement Policy (OMB), testified that Federal agencies are required to develop their budget and procurement requests based on guidelines established by OMB. For capital budgeting purposes, he said agencies are required to prepare cost estimates for multi-year outlay programs and these estimates are evaluated by OMB. With regard to leasing proposals, Mr. Sowle stated that current OMB guidelines do not require agencies to consider the revenue loss from tax benefits available to lessors in making their cost estimates; and that OMB currently does not assess both outlays and revenue loss as part of its agency review activity. Mr. Sowle tated while certain OMB circulars may provide limited guidance regarding leasing proposals, Federal procurement policies and regulations cover primarily the direct purchase of goods and services.

Mr. Allan W. Beres, Assistant Administrator for Acquisition Policy (GSA), testified that leasing is not a practical acquisition alternative for many of the common-use products purchased by GSA. However, Mr. Beres indicated leasing may be appropriate with respect to certain types of property such as data processing and telecommunications equipment. He said neither the basic OMB guidelines in this area nor GSA regulations specifically require consideration of the tax and revenue consequences of the transaction.[2]

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[2]Mr. Beres submitted for the record a letter to the Subcommittee from GSA Administrator, Mr. Gerald P. Carmen. In his correspondence, Mr. Carmen states that the purchase of property is preferable to leasing particularly in cases where the Government's need for the property extends beyond the lease term. In addition to probable lower financing costs, Mr. Carmen states direct purchase provides greater visibility and control on Government costs.

V. DISCUSSION OF ISSUES AND SUBCOMMITTEE RECOMMENDATIONS

Leasing is an established method of obtaining the use of property where direct ownership is undesirable because, for example, use of the property for only a small fraction of its useful life is desired (e.g., renting a car), cash flow or credit problems restrict the ability for direct property acquisition or because of State or Federal law places restrictions on the ownership of the property (e.g., banking law restriction on the ability of banks to own certain property).

There are many forms of lease transactions, including operating leases, tax-exempt lease-purchase arrangements, and sale leaseback agreements. Operating (or true) leases are arrangements in which the lessee acquires use, but not ownership of property for a term that is shorter than the asset's useful life. Lease terms are often only a year, and the property belongs to the lessor both during and upon expiration of the lease. Under current law, the lessor must pay income taxes on the lease or rental payments. If the lessee is a governmental unit, the lessor may claim some, but not all of the benefits of ownership. Specifically, depreciation deductions are permitted, but the investment tax credit is not available, unless the property involved is an old or historic building that has been substantially rehabilitated. Operating leases have been commonplace for many years for a wide variety of property and equipment.

In contrast to operating leases, lease-purchase agreements are essentially installment sales contracts providing for the acquisition of property by a governmental entity. Under the contract, the governmental unit makes periodic payments representing installments of the purchase price of the property plus interest. At the end of the contract term, the governmental unit either owns the property or may acquire it for a nominal sum. The interest portions of the payments are exempt from Federal taxation, provided that the contract is an obligation of a state or local governmental unit and is structured as an installment sale, rather than as a true lease. The investment tax credit is not available.

Under sale-leaseback arrangements, public property is sold to a private entity and simultaneously leased back for use by the governmental entity. The private entity makes an equity investment in the property and in return gets the benefits of ownership, which minimally will include depreciation deductions under the Accelerated Cost Recovery System (ACRS). The government entity receives a cash payment and an opportunity to lease back the property at a reduced rent reflecting the lessor's tax benefits. Sale-leaseback arrangements have become more attractive as a result of newly shortened cost recovery periods under ACRS and the investment tax

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credits available for the rehabilitation of buildings 30 years or older, or of historic significance. (With the exception of older buildings, the ITC is generally not available for property used by government entities.)

For private equity investors, sale-leaseback arrangements provide tax benefits of ACRS deductions (and the ITC where available). In addition, lease payments provide a continuous rental income stream. (The rental income is fully taxable and, as such, differs substantially from payments made under lease-purchase agreements.) Often tax-exempt industrial revenue bonds (IRBs) are used to finance acquisition and rehabilitation costs, and thus, investors will benefit additionally from tax-exempt financing.

The Subcommittee recommendations address leasing transactions by Federal agencies and non-taxable entities which involve ACRS and ITC tax benefits. Such transactions by nontaxable entities raise important tax and budget policy issues. The tax benefits indirectly obtained through leasing by Federal agencies, State and local governments, and tax-exempt organizations through leasing come directly out of Treasury receipts and increase the Federal deficit. Since the revenue loss to the Treasury does not appear in the budget, and is not broken down by agency or function, it is difficult for Congress to evaluate the total costs of leasing. Moreover, many transactions blur the distinction made in the tax law between "true" leases and financing arrangements or conditional sales and may permit an unintended Federal tax subsidy on the basis of the form rather than the substance of transactions. These issues and the Subcommittee findings are discussed below. Certain Subcommittee recommendations are also presented.

A. Federal Government Long-Term Leasing of Major Assets is More Costly than Purchase of the Same Assets:

Explanation:

When it leases property, the Government's capital cost consists of rental payments and the revenue loss as a result of net tax benefits available to the lessor. For the lessor to be willing to enter into the lease, these rental payments and net tax benefits must be large enough to cover the lessor's capital costs, which are the following: interest and principal payments to lenders for loans used to acquire the property, a rate of return on equity provided by investors and used to purchase the property, fees paid to third parties for setting up and carrying out the lease, and the decline in the value of the property as it ages. The market rate of interest paid

by the lessor and the rate of return expected by its shareholders generally exceed the interest rate on government bonds, because of the government's superior credit[3] Therefore, when the government leases, it compensates the lessor for greater financing costs than the Government would have borne had it borrowed funds and purchased the property. Similarly, to the extent that extra fees are involed in arranging a sale and lease, and not merely a sale, the Government compensates the lessor for expenses that the Government would not have borne. Expressed as an equation,[4] the excess cost of long-term leasing is:

Excess Cost = Lessor Profit + Lessor Financing Cost - Price

This additional capital cost of long-term leasing does not necessarily mean that all Federal leasing is inappropriate. Leasing may be desirable with respect to certain types of property. As pointed out by several witnesses during the Subcommittee hearing, there may be other considerations that outweigh its extra cost. However, the additional capital cost does suggest that there should be a presumption against long-term leasing by the Federal Government.

B. A Uniform Government-Wide Accounting Method is Needed to Provide for Accurate Analysis of the Total Costs Of Long-Term Government Leasing Programs. Executive Branch Review Procedures Regarding Multi-Year Lease Transactions Should Incorporate this Method:

Recommendation:

1. The Office of Management and Budget (OMB) should promulgate specific guidelines regarding the methodology for assessing the total Government cost of long-term leasing proposals, including the revenue loss resulting from lessor tax benefits.

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[3]The difference between the lessor's and the Government's borrowing rate is attributable to the market's perception that the lessor has a greater risk of default than the Government. This can be thought of as a risk premium on the lessor's debt. Normally, the lessor's cost of funds exceeds the Governments by this risk premium which is passed to the Government in the form of higher rents. That is, the Government pays an excess cost to lease whenever it contracts with a lessor whose borrowing rate is larger than its own.

[4]The lessor's profit equals rent plus residual income, less the sum of taxes (reduced by tax benefits), and financing costs. The lessor's tax benefit is the reduction in tax liability as a result of ACRS and in some cases the ITC. Financing costs are debt service and fee payments.

2. The Department of Treasury and OMB should comprehensively review the legal, revenue and budget effects of proposed agency leasing transactions. The Department of Treasury should prepare revenue loss estimates for proposed leases which are more than 50 percent of the usual life of the property.

Explanation:

Various departments within Federal agencies develop and analyze budget and procurement requests based on guidelines established by OMB. For capital budgeting purposes, Federal agencies are required by OMB to assess the costs of multi-year outlay programs. However, with regard to leasing transactions, the hearing record indicates OMB guidlines do not currently require agencies to consider the revenue loss as a result of tax benefits available to lessors in making cost analyses. In addition, OMB does not currently assess the total costs (outlays and revenue loss) of proposed leasing transactions as part of its agency review activities.

At the Subcommittee's request, the staff of the Joint Committee on Taxation (JCT) developed a method of accounting for Government long-term leases which includes an analysis of total Government costs, including revenue loss as a result of lessor tax benefits. The accounting method is summarized in Table 1 below.

Table 1--Economic Accounts: Lease Vs. Buy

Agency Finance Method	Agency Cost	Treasury Cost	Total Government Cost
Lease.....	Rent..... +Residual.....	Tax benefits....	Rent +Residual +Tax benefits
Buy.....	Purchase price	.....	Purchase price
Lease minus buy	Rent..... +Residual -Purchase price	Tax benefits....	Rent +Residual +Tax benefits -Purchase price

SOURCE: Joint Committee on Taxation staff study.

The accounting method[5] described above can be used to compared the total Government cost of leasing and buying. The additional costs of leasing can be allocated to three sources: (1) the lessor's profit, (2) the difference between the lessor's and the Government's cost of financing, and (3) the legal and administrative fees associated with the lease.

As a case example, the methodology described above was applied to a TAKX ship lease/charter agreement supplied to the Subcommittee by the Department of the Navy. The results of the analysis are summarized in Table 2 below.[6]

Table 2--Change in Government's Capital Cost by Leasing Instead of Buying Maersk Vessel Number Three

[In millions of dollars in present value, discounted at 10.25 percent annually]

Item	Navy Account	Treasury Account	Government Account
Cost, New Ship	-178.2		-178.2
Rental Payments	131.7	-59.2	72.5
Tax Benefits, ACRS . . .		81.2	81.2
Cost, Used Ship	9.5	-4.4	5.1
Tax Benefit, Interest Deductions		39.5	39.5
Tax Benefit, Amortized Fees		.7	.7
TOTAL	-37.0	57.8	20.8

SOURCE: Joint Committee on Taxation staff study

[5]Economic accounts can be calculated on a pre-tax or an after-tax basis. The pre-tax method expressed in Table 1, discounts before-tax outlays at a before-tax discount rate, while the after-tax method discounts after-tax outlays at an after-tax discount rate. Although both methods yield similar results, the pre-tax method is easier to implement since tax reflows to the Treasury need not be measured. Some analysts have claimed that while leasing appears unfavorable to the Government from a pre-tax point of view, the after-tax accounting method shows leasing to be advantageous. The analysis conducted by the staff of the Joint Committee on Taxation indicates that whether analyzed on a pre-tax or after-tax basis, long-term leasing is more expensive to the Government than buying. An after-tax methodology is described in the JCT print Tax Aspects of Federal Leasing Arrangements.

[6]The items in the table are expressed in dollars of constant value, so that they can be compared directly.

The table is divided into three columns. The Navy account shows the change in outlays, over the useful life of the ship, when it is leased rather than purchased. The Treasury account shows the change in tax revenues when the ship is leased. The Government account is the sum of the Navy and Treasury accounts. It shows the total change in the Government's capital cost for the ship due to long-term leasing instead of buying, and illustrates the shift of expenditures from the Navy to the Treasury.

In summary, Table 2 shows that the Navy will save as estimated $37 million in on-budget expenditures from the $178.2 million purchase price of the ship. However, the Treasury will lose approximately $57.8 million arising from tax benefits to the shipowner. Thus, the total cost to the Government of leasing the ship is $199 million, $20.8 million more or 11.7 percent more than direct purchase. The Navy's TAKX program involves lease/charter of 13 ships. In total, leasing all 13 ships will cost the Government an additional $270 million.

Federal procurement policies and implementing regulations cover primarily the direct purchase of goods and services and only indirectly address leasing transactions. Two OMB policy documents give guidance to Federal agencies when contemplating leasing. OMB Circular No. A-94 pertains to personal property and prescribes a cost-benefit analysis for procurements which extend three years or longer. The circular prescribes a discount rate and procedures for ascertaining cost-benefit ratios of competing alternatives. OMB Circular No. A-104 requires comparative cost analysis prior to the acquisition of real property valued at $500,000 or more. In addition, the General Services Administration (GSA) has issued a number of regulations requiring consideration of the most economic property acquisition alternatives.

The hearing record indicates that existing procurement guidelines may not be very useful in assessing the cost of long-term leasing proposals compared to purchases. For example, neither OMB guidelines nor GSA regulations require agencies to consider the revenue loss as a result of tax benefits available to lessors in analyzing leasing costs.

The Subcommittee believes specific guidelines regarding methodology for assessing total Government costs of long-term leasing proposals, including the revenue loss resulting from lessor tax benefits, should be promulgated by OMB. The Treasury Department should assist agencies by preparing revenue loss estimates for long-term lease proposals, and such revenue and budget effects should be comprehensively reviewed by OMB and Treasury.

C. Congressional Review Procedures Regarding Proposed Long-Term Lease Transactions Can Be Improved:

Recommendation:

1. Prior to the issuance of Request for Proposals (RFP's) for multi-year lease transactions, agency authorizing Committees, the Committees on Appropriations and the tax-writing Committees should be notified. Lease transactions with durations of more than 50 percent of the useful life of the property should receive prior Committee notification.

2. Agency notices or approval requests should contain information on the total costs of the lease (outlays and revenue loss estimates) and a justification of leasing as the procurement method rather than direct purchase.

Explanation:

The Subcommittee has identified only two notice or approval provisions regarding proposed long-term lease transactions under existing law. Congressional approval is required for real property leases with annual rental charges in excess of $500,000. The fiscal year 1983 Defense Authorization Act (P.L. 97-252) contains a notification requirement for certain Navy lease/charter transactions.

In addition to Treasury revenue loss from long-term leases, the Subcommittee is concerned about the impact of leasing on the budget process. Lease procurements are accounted for differently than ordinary purchases. For example, lease obligations normally appear in the operation and maintenance (O&M) budget of Federal agencies, rather than in their capital budgets, which to some extent obscures the multi-year financial commitment. This may inadvertently disguise the nature of the outlays and reduce accountability.

A Federal department multi-year procurement program is funded, initially, by a budget authorization which appears in the procurement portion of the department's budget account. The actual cash expenditure in each year of the procurement program appears as an outlay item in the procurement portion of the budget account. If the department acquires the same property through a leasing arrangement, the authorization for cumulative lease payments does not appear as a separate item in the budget. The annual rental payments appear as an outlay item in the O&M budget rather than in the procurement account.

Long-term leasing also distorts the budget process to the extent that procurement costs are shifted from the department's budget to the U.S. Treasury through reduced tax revenues. In the Navy transaction examined by the Subcommittee, 29 percent of the procurement cost was shifted to the Treasury. Since the portion of the department's procurement program

paid for by reduced tax revenue does not appear as a separate budget item, the total Government cost of procurement cannot be ascertained from the unified Federal budget.

Because these discrepancies between budgetary accounting for procurement by purchase and by lease make it difficult to determine the total government costs of Federal department long-term leasing programs, the Subcommittee believes agency authorizing Committees, the Appropriations Committees, and the tax-writing Committees should be notified prior to issuance of Request for Proposals (RFPs) for long-term lease transactions.

In order to evaluate the efficiency of long-term Government leasing, it is useful to divide the services provided by lessors into four categories: (1) purchasing, (2) financing, (3) operating and maintaining, and (4) reselling. The relevant question is whether a lessor can perform these tasks at a lower cost than the Government.

In a long-term lease, the lessee exercises continuous control over the property throughout the useful life of the property; while in a short-term lease, the lessee controls the property for only a small proportion of its service life. If the property is useless to anyone but the current lessee, the lease must be long-term in nature. Examples include equipment which has been customized to the lessee's operation, or a plant which is immobile (or movable only at high cost). On the other hand, property which can be used by a large number of lessees, is standardized in design, and relatively easy to transport, is more suitable for the purposes of short-term leasing. Example include office equipment and automobiles.

In general, it is unlikely to be cost-effective for the Government to procure property through a long-term lease, since the lessor seldom has a cost advantage in any of the four tasks enumerated above. First, if the Government intends to hold onto the property for its entire useful life, there are no reselling costs involved. Second, the lessor will generally have a purchasing cost advantage only in circumstances where he is a larger buyer than the Government agency. Third, as previously discussed, because of the Government's superior credit, the lessor will almost never have lower financing costs. And, fourth, if the lessor has lower operating and maintenance (O&M) costs then the least costly option is likely to be purchase of the property and a contract with the lessor only for O&M services.

Short-term leasing, on the other hand, may be cost-effective for Government agencies. Purchasing can be uneconomical when the Government intends to use the property for only a small portion of its service life because the buying and reselling costs are written off over such a short period of use. However, even short-term leases are not necessarily cost-effective in every instance because lessors generally have higher financial costs than the Government, which are passed through (along with the lessor's profit) in the form of higher rental charges.[7]

Apart from cost considerations, other Government policies may favor direct purchases rather than leasing arrangements. For example, in the case of a construction project, involving a substantial number of jobs, Congress may not be able to ensure that a portion of these jobs are created in areas of high unemployment if the department finances the project through a leasing arrangement. Another example is a defense agency lease of military equipment. In the event of a military emergency, the interests of the lessor and the defense agency might differ considerably regarding the deployment of the property. Conceivably, a leasing arrangement could pose a serious threat to the national defense if such leased equipment were needed in an emergency.

The aforementioned comments are not intended as a condemnation of long-term leasing arrangements. Such transactions are not necessarily inappropriate and should be evaluated on the basis of cost, budget, and other relevant criteria. However, the Subcommittee believes Executive branch agencies and the Congress should receive complete information regarding the total costs of proposed long-term leases (outlay and revenue loss estimates), the intended use of property to be acquired, and a justification of leasing as a procurement method. This information is essential for comprehensive evaluation of long-term lease proposals.[8]

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[7]Certain "short-term" transactions which involve numerous revenue options (and significant termination costs) are essentially long-term leases.

[8]From the oversight perspective of Congress, the importance of these issues varies according to whether the non-taxable lessee is (a) a Federal department, (b) a State or local government, or (c) a charitable or educational organization. Leasing activities by State and local governments or other non-taxable entities do raise important Federal policy concerns (e.g., Federal revenue loss) developed in this report.

D. Congressional Intent Regarding the Availability of the Investment Tax Credit for Lessors Who Lease Property to the Federal Government or Other Non-Taxable Entities for Tax-Exempt Activities Should be Clarified:

Recommendation:

Clarify by statute that the investment tax credit is not available for property used by the Federal government or other non-taxable entities and obtained by a long-term lease structured as a service contract or similar arrangement.

Explanation:

The investment credit (ITC) is unavailable with respect to property that is used by a governmental unit (governmental use restriction)[9] and with respect to property used by a tax-exempt organization unless the property is used predominately in an unrelated trade or business of that organization. With respect to the governmental use restriction, one court has held (and the Internal Revenue Service has ruled) that the investment credit can be claimed where the governmental unit essentially has contracted for a service to be provided by the owner of the equipment rather than for the use of the equipment itself.

Under Treasury regulation 1.48-1(k), "property used by a governmental unit" means only property owned by or leased to a governmental unit. In Revenue Ruling 68-109, 1968-1 C.B. 10, the Internal Revenue Service (IRS) ruled that property provided to a customer as an integral part of a service is not "used by" the Government within the meaning of Internal Revenue Code section 48(a)(5).[10]

The only judicial decision dealing with the service contract exception to the governmental use restriction is Xerox Corporation v. United States, 656 F.2d 659 (Ct.Cl. 1981). In Xerox, a manufacturer provided duplicating machines to the Federal Government. In a revenue ruling involving the same

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[9]Under present law, the governmental use restriction does not apply in the case of the rehabilitation tax credit.

[10]Revenue Ruling 68-109 involved communications equipment installed by a public utility on the premises of governmental units. The Internal Revenue Service (IRS) has issued a number of other rulings applying the service contract exception. (See, e.g., Rev. Rul. 72-407, 1972-2 C.B. 10 and LTR 7847045, August 28, 1978.)

basic facts as in the Xerox case, IRS held that the agreements were leases (Rev. Rul. 71-397, 1971-2 C.B. 63). Accordingly, the property was not eligible for the investment tax credit. The Court of Claims rejected the taxpayer's contention that its agreements were short-term leases, which are eligible for an exception to the governmental use restriction. However, the court held that the machines were eligible for the investment tax credit because they were provided as an integral part of a service contract.

Essentially, the Court of Claims based its decision on the Internal Revenue Service's own formulation of the service contract exception, as set forth in the holdings of published and private rulings (other than Rev. Rul. 71-397). The court rejected the Government's contention that the service contract exception would not apply where the customer's own personnel operate the machines, because this factor was present in the first ruling adopting the exception (i.e., Rev. Rul. 68-109, 1968-1 C.B. 10). The court emphasized that Xerox was not a case in which the cost or value of the property dominated the price of the total arrangement. The court also noted that, conceivably, its decision would be different if the Treasury regulation had formulated the precise confines of the service contract exception.

Although the Xerox case and recent published and private letter rulings do not articulate a single test for use in determining whether an agreement is a service arrangement or a lease, the Subcommittee is concerned that it may be relatively easy to avoid the denial of the investment tax credit by restructuring long-term Government leases as service contracts.

E. Congress Should Re-Examine Cost Recovery Deductions for Lessors Who Enter Into Long-Term Lease Transactions or Similar Arrangements With the Federal Government or Other Non-Taxable Entities:

Recommendation:

Congress should consider limiting cost recovery deductions for property leased to non-taxable entities so that the tax system does not make leasing more attractive to these entities than direct ownership. These rules should be extended to arrangements similar to leases (e.g., service contracts).

Explanation:

As a general rule, entities such as Federal agencies, State and local governments, and charitable and educational

organizations are ineligible to take cost recovery deductions (or the investment tax credit) when they purchase property because they are tax-exempt. In certain circumstances, the law permits taxable companies to purchase and claim certain tax benefits on assets which are subsequently leased to non-profit entities. In these lease transactions, a portion of the tax benefit available to the lessor may be passed through to the non-taxable lessee in the form of lower rents. Thus, certain leasing arrangements permit tax benefits to flow through to non-taxable entities which are not eligible for them on their own account. This can result in a negative effective tax rate on the assets leased by non-taxable entities. In effect, nontaxable entities through leasing receive the benefits of income tax deductions (i.e., cost recovery, interest deductions and, in certain cases, the investment tax credit) but, unlike taxable entities, have no corresponding liability to pay tax.

Sale-leaseback transactions make it possible for non-taxable entities to benefit indirectly from tax deductions normally unavailable to them. Under these arrangements, public property is sold to a private entity and simultaneously leased back for use by the governmental entity. The private entity makes an equity investment in the property and in return gets the benefits of ownership, which minimally will include ACRS deductions. The government entity receives a cash payment and an opportunity to lease back the property at reduced rates reflecting the lessor's tax benefits. Most sale-leaseback arrangements involved the rehabilitation of existing property or the construction of new facilities. Typically, sale-leasebacks are "leveraged" transactions[11] which involve at least four primary participants: a municipality, county, state, or other nontaxable entity which owns, sells, and will subsequently lease back the property; a private equity investor; an underwriter, or lender; and a public authority, which may issue tax-exempt industrial revenue bonds (IRBs) to finance acquisition and construction costs.

As an example, suppose a city government wishes to acquire a new $4 million office building. The conventional procedure is for the city to hold hearings and to have a referendum on a $4 million bond issue. Alternatively, the city government could, without a bond referendum, enter into a sale-leaseback arrangement, and use general revenues to pay rent to the lessor. Due to tax benefits, the sale-leaseback would cost the city less than constructing the building with the proceeds of a bond issue, particularly if the acquisition and construction costs were financed with tax-exempt IRBs. The city will benefit both from the equity payment it receives from the partnership, which it can invest in

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[11] In other words, where the property is financed by a non-recourse loan from a third party.

high-yielding securities, and from reduced rent payments, which flow from the lessor's tax deductions. An estimate of the present value of the city's rental and residual payments might be $3 million. The lessor can afford to set rental payments below the purchase price of the building because of the tax benefits he receives from deductions for accelerated depreciation and interest expense. The value to the lessor of these tax benefits could easily amount to $1.5 million. Of these tax benefits, $1 million could go towards the purchase price of the city hall building, and $0.5 million would be left over to cover the lessor's profit and administrative costs. Although there is no line item in the Federal budget, the city government has nevertheless been able to pay for one-quarter of its new city hall with Federal tax dollars. This could be viewed as an indirect form of revenue sharing, and it may be a less efficient way to aid State and local governments. Also, some of the Federal "aid" is absorbed by intermediaries involved in structuring the lease.

Sale-leaseback arrangements have become more attractive as a result of newly shortened cost recovery periods under the ACRS system and investment tax credits available for the rehabilitation of buildings 30 years or older or of historic significance. (With the exception of older buildings the investment tax credit is generally not available for property used by government entities.)

For private equity investors, sales-leaseback arrangements provide tax benefits of depreciation deductions and investment tax credits, where available. In addition, lease payments provide a continuous rental income stream. The rental income is fully taxable. If IRBs are used to finance acquisition and rehabilitation costs, investors in them will benefit from tax-exempt borrowing.

Sale-leasebacks have been used or are being considered for convention centers, educational facilities, sewer systems and all manner of public buildings, from libraries to museums to city halls. (See Appendix C)

In addition to revenue sharing and grant programs, Congress currently assists non-taxable entities through the tax system by means of the exclusion from Federal tax of interest paid on municipal bonds. (The 1982 combined cost to the Treasury of the exclusion of interest on State and local housing, pollution control, hospital, industrial development, and general purpose bonds was over $10 billion.) Tax motivated leasing increases the amount of assistance that State and

local governments receive through the tax system.[12] Further, the Subcommittee is concerned that Federal tax policy may induce state and local governments and other non-taxable entities to circumvent conventional financing procedures which include public participation.

F. Many Recent Long-Term Lease Transactions, Including the Navy Lease Transactions, are Premised on Questionable Assumptions Regarding the Determination of Whether the Transaction is a "True" Lease as Opposed to a Financing Mechanism or Similar Arrangment:

Explanation:

To give taxpayers guidance in structuring leveraged leases, the Internal Revenue Service in 1975 issued Revenue Procedure 75-21, 1975-1 C.B. 715, and a companion document, Revenue Procedure 75-28, 1975-1 C.B. 752 (the guidelines). If the requirements of the guidelines are met, and if the facts and circumstances do not indicate a contrary result, IRS will issue an advance letter ruling under the nonsafe-harbor rules that the transaction is a lease and that the lessor is the owner of the property for Federal tax purposes. Even if the requirements are not met, a ruling might be issued based upon the general principles of the guidelines described below.

The specific requirements for obtaining a ruling under the guidelines are as follows:

1. Minimum investment: The lessor must have a minimum 20 percent unconditional at risk investment in the property.

2. Purchase options: In general, the lessee may not have an option to purchase the property at the end of the lease term unless, under the lease agreement, the option can be exercised only at fair market value (determined at the time of exercise). This rule precludes fixed price purchase

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[12]Because the magnitude of these leasing tax benefits is unknown, it is difficult for Congress to evaluate this type of assistance. Unlike housing or hospital bonds, for example, the use of leasing benefits is not restricted to any particular purpose. Furthermore, for both municipal bonds and leasing arrangements, Congress relies on intermediaries to pass through tax benefits to State and local governments. A sizable portion of the revenue loss to the Treasury may be drained away by these intermediaries instead of being passed through to State and local governments. Therefore, appropriated assistance may be more efficient than assistance through the tax system.

options, even at a bona fide estimate of the projected fair market value of the property at the option date. In addition, the lessor cannot have a contractual right to require the lessee to purchase the property (a put).

3. Lessee investment precluded: Neither the lessee nor a party related to the lessee may furnish any part of the cost of the property. The rationale is that a lessee investment may suggest that the lessee is in substance co-owner of the property.

4. No lessee loans or guarantees: As a corollary to the prior rule, the lessee must not loan to the lessor any of the funds necessary to acquire the property. In addition, the lessee must not guarantee any lessor loan.

5. Profit and cash flow requirements: The lessor must expect to receive a profit from the transaction and have a cash flow from the transaction independent of tax benefits.

6. Limited use property: Under Revenue Procedure 76-30, 1976-2 C.B. 647, property that is limited to use by the lessee (limited use property) is not eligible for lease treatment. The rationale is that if the lessee is the only person who could conceivably use the property, the lessor has not retained any significant ownership interest.

The IRS guidelines are not by their terms a definitive statement of legal principles and are not intended for audit purposes. They are designed to give taxpayers guidance in structuring lease transactions.

Leasing is an established method of obtaining the use of property where direct ownership is undesirable because, for example, use of the property for only a small fraction of its useful life is desired (e.g., renting a car), cash flow or credit problems restrict the ability for direct property acquisition or because State or Federal law places restrictions on the ownership of the property (e.g., banking law restriction on the ability of banks to own certain property). In many cases, government entities and other non-taxable entities lease for these same non-tax business reasons. However, in other cases, non-taxable entities who otherwise would choose to own property have entered into transactions characterized by the parties as leases because they can obtain indirectly, in the form of lower rents, tax benefits that are not allowed for property owned by nontaxable entities. These tax benefits come directly out of Treasury receipts and increase the Federal deficit. In these situations (i.e., those in which the non-taxable entity would probably have chosen direct ownership) the parties have sought to designate the taxable lessor as the property owner for Federal tax purposes, while

to the extent possible, placing the economic burdens and benefits of ownership on the non-taxable lessee. These transactions, blur the distinction made in the tax law between "true" leases and financing arrangements or conditional sales and may permit a Federal tax subsidy on the basis of the form rather than the substance of the transactions.

In general, a transaction may qualify as a lease, only if the lessor retains meaningful benefits and burdens of ownership. In the Navy lease transaction, the case example examined by the Subcommittee, the benefits and burdens of ownership retained by the lessor are very limited. Although the lessor and not the Navy, will be entitled to any residual value at the end of the lease, the effect of placing this economic benefit with the lessor is lessened by the fact that the parties have estimated that the ship will only have a value at the end of the lease of less than 1 percent of the purchase price. In combination, these factors raise questions as to whether the transaction is a lease.

The Internal Revenue Service has, however, issued a private letter ruling granting lease treatment for a lease of ships by the Federal Government, the terms of which are similar in many respects to the Navy transactions. Although private letter rulings cannot be used as precedents, the ruling creates disturbing implications involving the distinction between true leases and financing arrangements. The Subcommittee is concerned about any development that would, in effect, permit non-taxable entities to obtain a Federal tax subsidy by making minimal changes in the economic substance of transactions (normally structured as purchases), so that these transactions may qualify as leases eligible for tax benefits.

VI. CONCLUSION

Tax motivated lease transactions by nontaxable entities which involve ACRS deductions and the investment tax credit raise important budget and tax policy questions. When a non-taxable entity leases an asset it might have purchased, Federal income tax benefits are generated for the lessor and in part, may be passed through to the non-taxable entity as reduced rents. Thus, organizations that pay no income tax, nonetheless, can enjoy the benefits of income tax deductions and credits, at the expense of the Federal Treasury. To the extent that large lessors are able to reduce their tax liability, and to the extent that leasing reduces public participation in major capital projects, public confidence in the tax system may be eroded.

The Subcommittee believes these issues merit full Committee review and possible legislative action.

APPENDIX A

Summary of Navy TAKX Lease/Charter Arrangement

A. Structure of the TAKX Charter Arrangement. The TAKX charter arrangement involves three primary parties: (1) the Shipowner, (2) the Contractor, and (3) the Navy.

The charter arrangement also involves two basic agreements: (1) a lease of the ship under a "Bareboat Charter" between the Shipowner and (2) an agreement to provide ship transportation services under a "Time Charter" between the Contractor and the Navy. There is also a Credit Agreement, involving financing, and an Operating Agreement between the Contractor and a related party for performing the actual services.

The Subcommittee obtained copies of an "Agreement to Charter" and a "Time Charter" (referred to collectively as the "Time Charter") relating to one of the TAKX ships. The Subcommittee understands that the Navy has entered into substantially similar arrangements with respect to all of the TAKX ships. The Joint Committee on Taxation (JCT), at the Subcommittee's request, examined the lease/charter documents. The following description is based largely on the JCT review. Additional description is contained in the Joint Committee on Taxation staff study entitled, "Tax Aspects of Federal Leasing Arrangements". Related contracts (e.g., the "Bareboat Charter," the "Credit Agreement", and the "Operating Contract") have not been examined. The lease/charter characteristics are described below.

The documents indicate that the Contractor is responsible for arranging for financing and construction of the ships. It is also responsible for obtaining the Shipowner, which will be a partnership comprised of equity investors. Once a Shipowner has been obtained, the Shipowner will contract for the construction of the TAKX ship in accordance with the Navy's specifications. After construction of the ship, the Shipowner will convey the ship to the Contractor under the Bareboat Charter. The parties contemplate that for Federal income tax purposes, the Bareboat Charter will be treated as a lease agreement under which the Shipowner is lessor and the Contractor is the lessee.

Under a Time Charter with the Navy the Contractor must provide transportation services to the Navy and ensure that the TAKX ship is manned, equipped, and maintained in accordance with the Navy's requirements. The master, officers, and crew will be civilians hired by the Contractor, subject to Navy approval. The parties contemplate that for Federal income tax purposes the Time Charter will be treated as a "service contract" and not a lease. Services will actually be performed by an affiliate of the Contractor (referred to as the "Operator") under a separate operating contract.

Pursuant to the Time Charter, the Navy is required to make two types of payments: (1) capital hire (which is computed by reference to the amounts required to repay--with interest or a return--the debt financing and equity investment of the Shipowner, taking into account the net income tax benefits for the Shipowner that are generated by the Bareboat Charter), and (2) operating hire (which covers the costs of operating the TAKX ship and the Contractor's profit). In addition to these basic charges, the Navy assumes a variety of other economic burdens described below.

B. Economic Risks Borne by the Parties. The Navy bears significant economic risks resulting from the acquisition and operation of the TAKX ship. The Shipowner is guaranteed an after-tax rate of return and is otherwise protected against the loss of its investment. The primary risks borne by the Contractor are limited to acts of negligence by the Contractor or its agents.

The capital hire payments are based on an assumption that permanent financing can be obtained at 11 percent. If the interest rate at which permanent financing is actually obtained is higher, the capital hire rate will be adjusted upward to reflect the higher interest rate. Thus, the Navy alone bears the risk that interest rates will rise and, in effect, the Contractor is protected against the risk that operation of the TAKX ship will become unprofitable.

The contractor is required to secure full form marine insurance coverage although the costs of insuring the hull and machinery and costs of indemnity coverage are included in the operating hire rates and, thus, paid by the Navy. Essentially, the Navy bears the risk that the required insurance will be unavailable and/or that the costs of such insurance will rise. More importantly, in the event that the insurance proceeds are not sufficient to make the Shipowner whole, or are not forthcoming, both the Contractor and the Shipowner can look to the Navy for indemnification.

C. Risks Associated with the Characterization of the Time Charter for Federal Income Tax Purposes. The Navy is obligated to reimburse the Contractor for any amounts required to make the Shipowner whole if (1) the Shipowner suffers the loss of any tax benefits as a result of the Time Charter being treated as a lease for Federal income tax purposes, or (2) the Shipowner is required to include in gross income the value of any nonseverable improvements made to the ship at the Navy's request. The Navy can direct the Shipowner to contest any disallowance of tax benefits, in which case the Navy will also pay the costs incurred by the Shipowner in contesting such disallowance. The Navy is not required to indemnify the Shipowner for any loss of Federal income tax benefits attributable to characterization of the transaction as a conditional sale to the Navy.

APPENDIX B

CHANGE IN GOVERNMENT'S CAPITAL COST BY LEASING INSTEAD OF BUYING MAERSK VESSEL NUMBER THREE

[In millions of dollars in present value, discounted at 10.25 percent annually]

Item	Navy Account	Treasury Account	Government
Cost, New Ship	-178.2		-178.2
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Tax Benefits, Amortized Fees		.7	.7
TOTAL	-37.0	57.8	20.8

In the Navy account, the government, by leasing, saves the cost of purchasing the ship. This amount, $178.2 million, does not include the additional $4.2 million in legal fees and other fees which were paid by the lessor for arranging the lease and which the lessor treats as a capitalized cost. Then, over the term of the lease, the Navy will pay capital rents amounting to $131.7 million in present value. Finally, in order to have the ship after the 25-year lease expires, as the government would if it had purchased the ship initially, the Navy will pay an estimated $9.5 million in present value to acquire the used ship. This estimate is based on an assumed inflation rate of 6 percent and a 1979 study of economic depreciation commissioned by the Treasury, which determined that 7.5 percent is the best estimate of the annual rate of decline in the market price of ships and vessels (measured in inflation-corrected dollars on a declining balance basis). Adding all items in the Navy account, the leasing of this ship is estimated to reduce outlays by $37 million in present value.

In the Treasury account, leasing gives rise to income tax items for the lessor that the government would not provide to or assess against itself, were it the owner of the ship by purchase. The lessor is assumed to pay the top corporate tax rate of 46 percent. Thus, revenues are reduced by $81.2 million in present value for the 10 percent investment credit and cost recovery (ACRS) deductions allowed for the lessor's depreciable basis of $178.2 million. Solely for purposes of conforming with assumptions stated in the TAKX agreement, this assumed that the property is not subject to the general rule enacted in the Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248 (TEFRA), that depreciable basis must be reduced by one-half the investment credit allowed (Code sec. 48(q)). An

estimated $4.4 million of the ACRS benefit is recaptured when the government purchases the ship at the end of the lease. In addition, revenues are reduced in present value by $39.5 million for the lessor's interest deductions and by $0.7 million for the amortization of legal fees and other fees. Finally, revenues are increased in present value by $59.2 million for the lessor's rental income. Adding all items in the Treasury account, the leasing of this ship is estimated to reduce tax revenues by $57.8 million in present value.

Combining the accounts, the leasing of Maersk vessel number three is estimated to increase the government's capital costs of having the use of this ship by $20.8 million in present value. That is, the government's cost of this leased ship is estimated to be $199 million, approximately 11.7 percent higher than its purchase price. Inclusive of the residual value of the ship at the end of the lease, the lessor's after-tax rate of return on investment is estimated to be 14 percent.

APPENDIX C

NEWS ARTICLES REGARDING LONG-TERM LEASING

BY NONTAXABLE ENTITIES

Selling A Bridge

The Brooklyn Bridge for sale? The idea might not be so far-fetched. Austin, Corpus Christi and Atlanta are among the cities considering plans for private developers to own city hall, leasing it back to the city — following a practice already popping up in other Government sectors. (The Navy, for example, leases some ships.)

Stuart Goldenberg

Such transactions are not new. But accelerated depreciation, more generous tax credits and increased activity in leasing have prompted an explosion in interest. These plans appear to reduce costs because private investors can take tax-writeoffs not available to organizations that pay no taxes.

The trouble is that the tax breaks are beginning to cost the Federal Treasury big bucks in foregone tax revenues. Government officials are trying to figure out how much. "It's as if we've grabbed something by the tail, and at this point we don't know whether to hang on or let go," said Representative J. J. Pickle, a Democrat of Texas and a senior member of the House Ways and Means Commmittee. "This is really just a backdoor form of revenue sharing. The question is whether it is an efficient form."

Source: New York Times April 10, 1983

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Financing of Art Center Is Somewhat Convoluted

By Michel Marriott
Washington Post Staff Writer

When the Torpedo Factory Art Center, which was refurbished with $3.1 million in publicly backed funds, opens on Alexandria's waterfront next month, the city will not own a single concrete slab in the $5.4 million structure.

By using a financing scheme made possible by a recent Reagan administration-sponsored federal tax law, Alexandria officials say, the city will save $1.2 million over 15 years by redeveloping the old factory, selling it to a group of private investors and then leasing the building back. After 15 years, the city [illegible] the option of buying back the building at its then market value.

The Economic Recovery Tax Act of 1982, which enables local governments to make such a deal, is designed to allow jurisdictions essentially to sell tax breaks not available to governments to private developers, thus passing on part of the cost of redevelopment to the federal treasury instead of local taxpayers or private investors, officials said.

The investors profit by taking advantage of income tax credits associated with the ownership and restoration of aging property and through standard depreciation tax credits—advantages not available for governments because they don't pay income taxes.

Here is how the Torpedo Factory Art Center deal works, according to Bradford Hammer, Alexandria's Deputy City Manager for Finance:

• The city sold about $2.4 million in public bonds and borrowed $700,000 to renovate the building.

• The city, which is still negotiating the final details of its agreement, will sell the building for $5.4 million to Alexandria Arts Center Associates, a partnership of local investors and REALCO-Potomac, a West Orange, N.J., development company that is the primary partner in the surrounding $50 million redevelopment plan. Local investors are led by Charles R. Hooff III, whose grandmother was instrumental in the redevelopment of Old Town in the 1920s. Hooff said he is expecting six to 12 local investors whose names will be made public this month.

• Of the $5.4 million, $3.7 million will be made available to the private investors through the sale of industrial revenue bonds at substantially below-market interest rates by the Alexandria Redevelopment and Housing Authority. The investors will be responsible for paying off the debt.

• The investors will qualify for an income tax credit that permits them to deduct 20 percent of the building's $4 million renovation cost, which is $800,000. Along with depreciation tax credits and the city's monthly lease payments, the investors are expected make a $750,000 profit on the $5.4 million investment. Investors can chose to take advantage of the tax breaks or they can sell those breaks on the open market.

• Alexandria then will lease exclusive use of the building for 20 years with an option to buy it back after 15 years. The lease payments are still undetermined, but the total of the payments will not exceed $5.4 million, excluding the cost of maintenance, custodial and utilities, which the city must pay.

• The citywill invest a portion of the $5.4 million sale price and use it to help make the monthly lease payments. The rest of the money will be used to pay off the $3.1 million in debt it incurred to refurbish the Torpedo Factory Art Center.

"As long as the Internal Revenue Service doesn't crack down on the use of this," said Wesley C. Hough, of the non-profit Government Finance Research Center, which assisted Alexandria arrange the sale-leaseback, "... I think it will be the thing of the future."

Source: Washington Post April 3, 1983

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Nev. Lawmakers Told Lease Deal Needed to Open Basketball Facilities

By George Yacik

University of Nevada officials have told a state Assembly committee that they may not have enough money to open two new basketball pavilions on the Las Vegas and Reno campuses this fall without a tax-exempt leveraged lease deal.

Under the plan, the university would sell to investors and then lease back the 18,000-seat Las Vegas facility and the 12,000-seat Reno building. The Reno facility would also be used as a community center in conjunction with the local convention authority.

Mark Dawson, the university's vice chancellor for finance, told the Assembly Ways and Means Committee that the two pavilions could be sold for about $60 million and the university would lease them back for 55 years through a $17 million tax-exempt bond issue. The arrangement, he said, would provide the university with $1.5 million in operating funds for five to seven years.

Dorothy Gallagher, a member of the university's board of regents, said it would take three to five years before the two buildings begin to operate in the black. Whatever is left of the $1.5 million after that could then be used for other university purposes or be returned to the state treasury.

Joseph Crowley, president of the University of Nevada-Reno, said the pavilion on his campus is currently expected to run an operating deficit of between $400,000 to $500,000 because bids on the project were higher than anticipated and the school had to purchase additional costly fire protection.

"Now we're at the point where we don't have the money to open and operate the center," Mr. Crowley said.

Pat Goodall, president of the Las Vegas campus, said, "We are honestly not sure whether we can be self-supporting, and opening [the pavilion] is a question."

He said the cost of operating the facility ranges from $700,000 to $1 million a year. Some of that money should come from endowment funds, advertising, and the sale of special box seats.

Also testifying before the assembly panel were Bernard J. Mikell Jr., vice president in the investment banking department at Goldman, Sachs & Co. in San Francisco, and Harry Schrauth, assistant to the director of public works in Oakland, Calif.

Goldman, Sachs underwrote a tax-exempt leveraged lease deal for the Oakland Museum and the Oakland Auditorium. Mr. Schrauth told the committee his city is pleased with the results.

Source: The Bond Buyer
April 13, 1983

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College to Try Leasing To Wipe Out Its Debts

BENNINGTON, Vt.—Bennington College trustees have approved a first-in-the-nation finance plan designed to wipe out the debts of the expensive liberal arts school by leasing the 650-acre campus to private investors.

Meeting in New York, the trustees unanimously backed the "lease-leaseback" arrangement proposed by college President Michael Hooker.

Under Hooker's plan, investors would lease the southeastern Vermont campus and then lease it back to the school. The college would receive the cash up front to pay off a $2.5 million bank loan and would be able to pay the investors back at low interest rates over 20 years.

The investors include the college corporation and several alumni. They will receive a tax break on the depreciation of the buildings and on the mortgage they assume under the lease agreement.

"This college has always been in the vanguard of things since its founding, and it is in this venture that we are undertaking these things," said Susan Borden, chairman of the trustees.

Also at the meeting, the trustees approved increases in tuition and room-and-board fees that will put the price of attending the school at $13,510 next fall.

Source: Washington Post April 20, 1983

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APPENDIX D

LIST OF WITNESSES
TO APPEAR BEFORE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
ON
FEDERAL LEASING PRACTICES

MONDAY, FEBRUARY 28, 1983 - BEGINNING AT 10:00 a.m.

ROOM 1100 LONGWORTH HOUSE OFFICE BUILDING

Opening Statement: The Honorable Charles B. Rangel
Chairman, Subcommittee on Oversight

Followed by Statements by:
The Honorable J. J. Pickle
The Honorable Don Pease
The Honorable Howard Metzenbaum

Werner Grosshans, Deputy Director
Procurement, Logistics and Readiness Division
General Accounting Office

Everett Pyatt, Principal Deputy Assistant Secretary
Shipbuilding and Logistics
Department of the Navy

Lloyd Moseman, Deputy Assistant Secretary for
Logistics and Communications
Department of the Air Force

William A. Long, Deputy Undersecretary for
Acquisition Management
Department of Defense

J. Gregory Ballentine,
Deputy Assistant Secretary for Tax Analysis
Department of the Treasury

Donald Sowle, Director, Office of Federal Procurement Policy
The Office of Management and Budget

Alan Barris, Associate Administrator for Acquisition Policy
General Services Administration

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